

The question presented by this appeal is whether appellant qualifies as a "new" small business and thus is entitled to carry forward a net operating loss incurred during its first taxable year.

Appellant was incorporated on December 13, 1983, and commenced business on January 1, 1984. Appellant was formed by the incorporation of an interior design business. The interior design business was apparently two businesses operated as one "quasi partnership" in which the two "partners," Ms. Henricks and Ms. Scroggie, each reported 50 percent of the income and expenses on her respective individual return. (We will refer to the business conducted prior to the formation of the corporation as the "quasi partnership.") Upon formation of appellant, each "partner" contributed her interest to the corporation for 37.5 percent of the stock. The remaining 25 percent of the stock was issued to a third shareholder, Ms. McGinnis, for \$4,000 cash. Ms. McGinnis did not have a financial interest in the quasi partnership.

Prior to incorporation, the quasi partnership's business activity involved providing interior design services to individual residential homeowners. After incorporation, the business changed to that of providing interior design services for model homes built by developers of residential tract homes.

Appellant contends that it is a new small business as defined by sections 24416 and 24417, and filed amended returns for the income years ended September 30, 1985, and September 30, 1986, claiming as a deduction the net operating loss incurred in the income year ended September 30, 1984. Respondent treated the amended returns as refund claims and disallowed the refunds. This appeal followed.

Section 24416 provides for a deduction as a carryforward of a net operating loss of a "qualified taxpayer." (Rev. & Tax. Code, § 24416, subd. (a).) "Qualified taxpayer" is defined in section 24417 as a taxpayer fitting one of three definitions. It is the definition provided in subdivision (a) of section 24417 that is at issue here. Section 24417, subdivision (a), provides that a qualified taxpayer is a "taxpayer engaged in a new small business." (Rev. & Tax. Code, § 24417, subd. (a), emphasis added.) At issue in this appeal is the proper interpretation of the word "new."

Respondent contends that appellant is a continuation of the business operated by the quasi partnership and thus it is not a "new" business. Respondent relies on the Appeal of Carmel Mortgage Corporation, 89-SBE-031, decided by this board on November 29, 1989, wherein we held that the incorporation of a sole proprietorship mortgage brokerage business did not qualify for the special net operating loss carryforward provisions of section 24416 because there was no new business. Respondent argues that appellant is merely a continuation of the old business, and thus is not a "new" business.

Appellant argues that it is a new business. First, it argues that nature of the business changed. It argues that interior design for individuals is a different business than that of designing for model homes. For individuals, the designer works with the individual, attempting to blend what the person likes into a design for his or her home. The typical fees averaged \$5,000. On the other hand,

designing for model homes involves working with architects, builders and designers, in an attempt to develop a design that creates a "feel" for the house. This work requires coordination with vendors to insure timely installation of the furnishings, fixtures and accessories. The average job for model home design was approximately \$100,000.

Second, appellant argues that the ownership of appellant is different than that of the "quasi partnership." The quasi partnership was owned one-half each by Ms. Scroggie and Ms. Henricks. Appellant is owned by three people, Ms. Scroggie and Ms. Henricks owing 37.5 percent each and Ms. McGinnis owning 25 percent. Appellant contends that Ms. McGinnis' investment of \$4,000 represented important capital to assist the "new" business.

Finally, appellant argues that the management of the business operations is different. The quasi partnership had no employees and annual revenue of \$174,000. Appellant has grown to have revenue of \$2,500,000 and 12 employees. It argues that this size contributes to the different nature of the business.

In Appeal of Carmel Mortgage Corporation, supra, we discussed the purpose of section 24417. Citing the language of the predecessor statute to section 24417, we found that the purpose of this statute was to create a favorable environment for small businesses and to encourage the development of new businesses. We determined that this policy would be defeated if already existing businesses could take advantage of this statute by "merely changing their business form." (Appeal of Carmel Mortgage Corporation, supra.) We do not think that the instant case is governed by the Appeal of Carmel Mortgage Corporation. Appellant's business was not identical to the quasi partnership's business and thus the incorporation was not merely a change in form of the business. Resolution of this appeal then turns on deciding whether appellant was nevertheless a continuation of the old business or whether it was a "new" business. In other words, how different must the corporation's business be to be new?

In this case, we conclude that appellant was a new business. We think that designing for individuals is sufficiently different from designing for model homes such that appellant's business was different from that of its predecessor. The clients served are different. When designing for individuals, the quasi partnership would have a new source of business through referrals from satisfied customers. However, upon the formation of appellant, the clients with whom appellant did business significantly changed. It seems unlikely that appellant was referred any model home design business from the individual clients of the quasi partnership. Appellant, through its employees, was serving a new client base and thus a whole new source of business and network of referrals had to be developed.

The design objectives and the product delivery process of appellant also are different and require different skills than that of the quasi partnership. Appellant now works with architects and home designers to help homes sell. Appellant works with vendors to ensure that its design work is completed timely and correctly so that the model homes serve as a useful marketing tool. Previously, the business simply involved working with an individual homeowner. Other than general business skills, the demands of the two different types of customers are sufficiently dissimilar that we do not consider

appellant a continuation of the quasi partnership.

We think the growth in revenue and employees experienced by appellant as compared to the quasi partnership is less relevant in determining the "newness." While growth in revenue and employees certainly is the result the Legislature hoped would occur by encouraging the creation of new small businesses, growth alone does not make a business new. It may be possible that there is such a sudden increase in revenue and payroll that the business is new, but that certainly is not the case here.

We do reject appellant's contention that the change in ownership as a result of Ms. McGinnis becoming a shareholder is a factor in deciding that appellant is new. While Ms. McGinnis' significant percentage ownership does change the dynamics of ownership, we conclude the test of the "newness" of the business turns on the business activity and not the "newness" of the owners.

The mere change in form of an existing business implies that the incorporation did not cause the business to "skip a beat." It seems to us that serving a different type of clientele, which clients have different objectives where the new clients expect new types of services, is sufficiently different to be "new." The fact that appellant may not have actually "skipped a beat" is not relevant.^{2/} A taxpayer need not have actually lost money or struggled to be a "new" business as required by section 24417. Instead, the term "new" implies that the taxpayer is facing financial risks because it has no "track record" on which to rely. Here, appellant and its predecessor had no track record in interior design work for model homes and we have previously determined that appellant's business was sufficiently different from that of the quasi partnership such that we conclude that appellant was a new small business as defined in section 24417.

For the reasons discussed above, the action of the Franchise Tax Board in this matter must be reversed.

^{2/} Although appellant lost money the first year, the next two years it earned money, even after the modest salaries drawn by the shareholders.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claims of Two's Company Interiors for refund of franchise tax in the amounts of \$5,102 and \$394 for the income years ended September 30, 1985, and September 30, 1986, respectively, be and the same is hereby reversed.

Done at Sacramento, California, this 7th day of May, 1992, by the State Board of Equalization, with Board Members Mr. Sherman, Mr. Dronenburg, and Ms. Scott present.

Brad Sherman _____, Chairman

Ernest J. Dronenburg, Jr. _____, Member

Winnie Scott* _____, Member

_____, Member

_____, Member

*For Gray Davis, per Government Code section 7.9
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